GOVERNMENT OF INDIA
FINANCE
LOK SABHA

UNSTARRED QUESTION NO:5793
ANSWERED ON:03.05.2002
TAX RULES FOR DEEP DISCOUNT BOND
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Will the Minister of FINANCE be pleased to state:

(a) whether the new tax rules relating to deep discount bonds and modified tax treatment corrects the anomalies in the existing system; and

(b) if so, the details thereof?

Answer

MINISTER OF STATE IN THE MINISTRY OF FINANCE (SHRI GINGEE N. RAMACHANDRAN)

(a): Yes, Sir. The Government has issued a Circular No.2/2002dated 15.2.2002 on tax treatment of deep discount bonds and STRIPS.

(b): The tax treatment of deep discount bonds had certain anomalies:

(i) Taxing the entire income from such a bond on redemption as interest income gave rise to a sudden and huge tax liability in one year whereas the value of the bond had progressively increased over the period of holding.

(ii) Where the bond was redeemed by a person other than the original subscriber, such person became taxable on the entire difference between the bid price and the redemption price as interest income, since he was not able to deduct his cost of acquisition from such income.

(iii) A company issuing such bonds and following the mercantile system of accounting would have claimed a deduction of annual accrual of the liability in respect of such a bond for each year even though the corresponding income in the hands of the investor would be taxed only at the time of maturity.

The Circular on the tax treatment of deep discount bonds now removes the anomalies in the existing system. It, inter-alia, apart from other clarifications, provides that a person holding a deep discount bond will make a market valuation of the bond on the 31st March of each financial year in accordance with the guidelines issued by Reserve Bank of India for valuation of investments. The difference between the market valuations as on two successive valuation dates will represent the accretion to the value of the bond during the relevant financial year and will be taxable as interest income (where the bonds are held as investments) or business income, where the bonds are held as trading assets. In a case, where the bond is acquired during the year by an intermediate purchaser, the difference between the market value as on the valuation date and the cost for which he acquired the bond, will be taxed as interest income or business income, as the case may be, and no capital gains will arise as there would be no transfer of the bond on the valuation date.

Where the bond is transferred at any time before maturity date, the difference between the sale price and the cost of the bond will be taxable as capital gains in the hands of the investor or business income in the hands of a trader. For computing the capital gains, the cost of bond will be taken to be the aggregate of the cost for which the bond was acquired by the transferor and the income, if any, already offered to tax by such transferor.